APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DECIDED FEBRUARY 24, 2004

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

Nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, 03-2348

In the Matter of: KMART CORPORATION,

Debtor-Appellant

Additional intervening appellants: Knight-Ridder, Inc.; Handleman Company; Irving Pulp & Paper, Limited

Argued Jan. 22, 2004.

Decided Feb. 24, 2004.

Rehearing and Rehearing En Banc Denied May 6, 2004.*

Before EASTERBROOK, MANION, and ROVNER, Circuit Judges.

EASTERBROOK, Circuit Judge.

On the first day of its bankruptcy, Kmart sought permission to pay immediately, and in full, the pre-petition claims of all "critical vendors." (Technically there are 38

* Chief Judge Flaum did not participate in the consideration of this petition.

debtors: Kmart Corporation plus 37 of its affiliates and subsidiaries. We call them all Kmart.) The theory behind the request is that some suppliers may be unwilling to do business with a customer that is behind in payment, and, if it cannot obtain the merchandise that its own customers have come to expect, a firm such as Kmart may be unable to carry on, injuring all of its creditors. Full payment to critical vendors thus could in principle make even the disfavored creditors better off: they may not be paid in full, but they will receive a greater portion of their claims than they would if the critical vendors cut off supplies and the business shut down. Putting the proposition in this way implies, however, that the debtor must *prove,* and not just allege, two things: that, but for immediate full payment, vendors *would* cease dealing; and that the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off.

Bankruptcy Judge Sonderby entered a critical-vendors order just as Kmart proposed it, without notifying any disfavored creditors, without receiving any pertinent evidence (the record contains only some sketchy representations by counsel plus unhelpful testimony by Kmart's CEO, who could not speak for the vendors), and without making any finding of fact that the disfavored creditors would gain or come out even. The bankruptcy court's order declared that the relief Kmart requested—open-ended permission to pay any debt to any vendor it deemed "critical" in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on "customary trade terms" for the next two years—was "in the best interests of the Debtors, their estates and their

creditors". The order did not explain why, nor did it contain any legal analysis, though it did cite 11 U.S.C. § 105(a). (The bankruptcy court issued two companion orders covering international vendors and liquor vendors. Analysis of all three orders is the same, so we do not mention these two further.)

Kmart used its authority to pay in full the pre-petition debts to 2,330 suppliers, which collectively received about $300 million. This came from the $2 billion in new credit (debtor-in-possession or DIP financing) that the bankruptcy judge authorized, granting the lenders super-priority in post-petition assets and revenues. See *In re Qualitech Steel Corp.*, 276 F.3d 245 (7th Cir.2001). Another 2,000 or so vendors were not deemed "critical" and were not paid. They and 43,000 additional unsecured creditors eventually received about 10¢ on the dollar, mostly in stock of the reorganized Kmart. Capital Factors, Inc., appealed the critical-vendors order immediately after its entry on January 25, 2002. A little more than 14 months later, after all of the critical vendors had been paid and as Kmart's plan of reorganization was on the verge of approval, District Judge Grady reversed the order authorizing payment. 291 B.R. 818 (N.D.Ill.2003). He concluded that neither § 105(a) nor a "doctrine of necessity" supports the orders.

Appellants insist that, by the time Judge Grady acted, it was too late. Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization. See *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003). If the orders in question are invalid, then the critical

vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors. Confirmation of a plan does not stop the administration of the estate, except to the extent that the plan itself so provides. Compare *In re Hovis,* 356 F.3d 820 (7th Cir. 2004), with *In re UNR Industries, Inc.,* 20 F.3d 766 (7th Cir. 1994). Several provisions of the Code do forbid revision of transactions completed under judicial auspices. For example, the DIP financing order, issued contemporaneously with the critical-vendors order, is sheltered by 11 U.S.C. § 364(e): "The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." Nothing comparable anywhere in the Code covers payments made to pre-existing, unsecured creditors, whether or not the debtor calls them "critical." Judges do not invent missing language.

Now it is true that we have recognized the existence of a longstanding doctrine, reflected in *UNR Industries,* that detrimental reliance comparable to the extension of new credit against a promise of security, or the purchase of assets in a foreclosure sale, may make it appropriate for judges to exercise such equitable discretion as they possess in order to protect those reliance interests. See also *In re Envirodyne Industries, Inc.,* 29 F.3d 301, 304 (7th Cir. 1994). Thus once action has been taken to distribute assets under a confirmed plan of reorganization, it would take some extraordinary

event to turn back the clock. These appeals, however, do not question any distribution under Kmart's plan; to the contrary, the plan (which was confirmed after the district court's decision) provides that adversary proceedings will be filed to recover the preferences that the critical vendors have received. No one filed an appeal, which means that it is appellants in this court that now wage a collateral attack on the plan of reorganization.

Appellants say that we should recognize their reliance interests: after the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts). Continued business relations may or may not be a form of reliance (that depends on whether the vendors otherwise would have stopped selling), but they are not *detrimental* reliance. The vendors have been paid in full for post-petition goods and services. If Kmart had become administratively insolvent, and unable to compensate the vendors for post-petition transactions, then it might make sense to permit vendors to retain payments under the critical-vendors order, at least to the extent of the post-petition deficiency. Because Kmart emerged as an operating business, however, no such question arises. The vendors have not established that any reliance interest—let alone any language in the Code—blocks future attempts to recover preferential transfers on account of pre-petition debts.

Handleman Company, which received $49 million as a critical vendor, makes a different procedural objection: that the district court's order does not affect it because Capital Factors' notice of appeal did not name Handleman as an appellee. Handleman was not a "party" in the district court

and, consistent with the due process clause of the fifth amendment, cannot be bound by the district judge's decision—or so it says. We permitted Handleman to intervene in this court. Thus it is a party today and will be bound by *our* decision, so it is hard to see why it matters whether the district judge's resolution would have had independent effect.

Notices of appeal in bankruptcy must name "all parties to the judgment, order, or decree appealed from." Fed. R. Bankr. P. 8001(a)(2). Handleman was not a "party" to the critical-vendors order; Kmart was the sole party at the time. Kmart filed an *ex parte* application that did not specify any particular creditor. It had notified only 65 creditors of its impending request, and none of these was among the 2,000 vendors to be left high and dry. The bankruptcy judge's order likewise did not identify any creditor that acquired rights, for *no* creditor acquired rights. All the order did was authorize Kmart to pay any vendor that Kmart in its discretion deemed "critical." The party that Capital Factors had to name thus was Kmart itself, and this it did. If the lack of personal notice about the proceedings before the district judge deprived Handleman of due process, then Kmart's application to the bankruptcy judge deprived about 47,000 unsecured creditors of due process! That would render the critical-vendors order void, and Handleman would be worse off—for then it would have to repay the money even if the order's entry otherwise would have been lawful. But there is no constitutional obligation to make every creditor a party to every contested matter in the bankruptcy. As a rule, a trustee or debtor in possession represents the interests of many stakeholders. Kmart vigorously represented the interests of Handleman and the other vendors Kmart deemed "critical."

Other creditors must look out for their own interests and intervene if need be—as Handleman could have done had it devoted to these proceedings the care that a $49 million stake warrants. Handleman will be a party, and receive all the notice that the Constitution requires, if Kmart initiates a preference-recovery action against it. As a party in this court, Handleman will not be allowed to contest matters resolved here; even the 2,327 critical vendors that are not parties in this court must accept the precedential effect of our decision. No rule of law requires personal notice to all entities that might be affected by the precedential (as opposed to the preclusive) force of an appellate decision. Today's opinion affects thousands of "critical vendors" and other unsecured creditors; decisions by the Supreme Court may affect millions of persons. Only those persons who will be formally bound by a decision are entitled to individual notice, and then only when practical (the lesson of many a class action, see *Mirfasihi v. Fleet Mortgage Corp.*, 356 F.3d 781, 785-86 (7th Cir. 2004).) So there was no flaw in the notice of appeal or the district judge's view that Kmart and Capital Factors were the only parties to the proceedings.

Thus we arrive at the merits. Section 105(a) allows a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code. This does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988); *In re Fesco Plastics Corp.*, 996 F.2d 152, 154 (7th Cir. 1993). *Cf. United States v. Noland*, 517 U.S. 535, 542, 116 S.Ct. 1524, 134

L.Ed.2d 748 (1996). Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full. See *In re Oxford Management Inc.*, 4 F.3d 1329 (5th Cir. 1993); *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *In re B & W Enterprises, Inc.*, 713 F.2d 534 (9th Cir. 1983). We agree with this view of § 105. "The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986).

A "doctrine of necessity" is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of "necessity"—*see Miltenberger v. Logansport Ry.*, 106 U.S. 286, 1 S.Ct. 140, 27 L.Ed. 117 (1882); *Fosdick v. Schall*, 99 U.S. 235, 25 L.Ed. 339 (1878)— today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. *Miltenberger* and *Fosdick* predate the first general effort at codification, the Bankruptcy Act of 1898. Today the Bankruptcy Code of 1978 supplies the rules. Congress did not in terms scuttle old common-law doctrines, because it did not need to; the Act curtailed, and then the Code replaced, the entire apparatus. Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding

entitlements to trump the text. See, e.g., *Lamie v. United States Trustee*, __ U.S. __, 124 S.Ct. 1023, 1029-31, 157 L.Ed.2d 1024 (2004), *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242-46, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989); *Bethea v. Robert J. Adams & Associates*, 352 F.3d 1125, 1128-29 (7th Cir. 2003). See also *Noland* (courts lack authority to subordinate creditors that judges, as opposed to legislators, believe should be lower in the hierarchy).

So does the Code contain any grant of authority for debtors to prefer some vendors over others? Many sections require equal treatment or specify the details of priority when assets are insufficient to satisfy all claims. E.g., 11 U.S.C. §§ 507, 1122(a), 1123(a)(4). Appellants rely on 11 U.S.C. §§ 363(b), 364(b), and 503 as sources of authority for unequal treatment. Section 364(b) reads: "The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense." This authorizes the debtor to obtain credit (as Kmart did) but has nothing to say about how the money will be disbursed or about priorities among creditors. To the extent that *In re Payless Cashways, Inc.*, 268 B.R. 543 (Bankr. W.D. Mo. 2001), and similar decisions, hold otherwise, they are unpersuasive. Section 503, which deals with administrative expenses, likewise is irrelevant. Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses. Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow. See *Boston & Maine Corp. v. Chicago*

Pacific Corp., 785 F.2d 562 (7th Cir. 1986). Treating pre-filing debts as "administrative" claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.

That leaves § 363(b)(1): "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a pre-petition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. Capital Factors insists that § 363(b)(1) should be limited to the commencement of capital projects, such as building a new plant, rather than payment of old debts—as paying vendors would be "in the ordinary course" but for the intervening bankruptcy petition. To read § 363(b)(1) broadly, Capital Factors observes, would be to allow a judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step. See *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506 (1996); *Noland, supra.* Yet what these decisions principally say is that priorities do not change unless a statute supports that step; and if § 363(b)(1) is such a statute, then there is no insuperable problem. If the language is too open-ended, that is a problem for the legislature. Nonetheless, it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code. We need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1).

Appendix A

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. See generally *Bank of America v. 203 N. LaSalle St. Partners,* 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). For the premise to hold true, however, it is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation—a demonstration never attempted in this proceeding—but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries. See 11 U.S.C. § 362. Fleming Companies, which received the largest critical-vendors payment because it sold Kmart between $70 million and $100 million of groceries and related goods weekly, was one of

these. No matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make. Nor was Fleming likely to walk away even if it had a legal right to do so. Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean. Again Fleming illustrates the point. When Kmart stopped buying its products after the contract expired, Fleming collapsed (Kmart had accounted for more than 50% of its business) and filed its own bankruptcy petition. Fleming was hardly likely to have quit selling of its own volition, only to expire the sooner.

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for pre-petition transactions. Kmart could have paid cash or its equivalent. (Kmart's CEO told the bankruptcy judge that COD arrangements were not part of Kmart's business plan, as if a litigant's druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a $2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest

way to do that would have been to put some of the $2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. For all the millions at stake, this proceeding looks much like the Chapter 13 reorganization that produced *In re Crawford,* 324 F.3d 539 (7th Cir. 2003). Crawford had wanted to classify his creditors in a way that would enable him to pay off those debts that would not be discharged, while stiffing the creditors whose debts were dischargeable. We replied that even though classification (and thus unequal treatment) is possible for Chapter 13 proceedings, see 11 U.S.C. § 1322(b), the step would be proper only when the record shows that the classification would produce some benefit for the disfavored creditors. Just so here. Even if § 362(b)(1) allows critical-

vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.

AFFIRMED.

APPENDIX B — MEMORANDUM OPINION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED APRIL 10, 2003

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

No. 02 C 1264.

April 10, 2003.

CAPITAL FACTORS, INC.,

Appellant,

v.

KMART CORPORATION,

Appellee.

MEMORANDUM OPINION

GRADY, District Judge.

Capital Factors, Inc. appeals from four final orders of the bankruptcy court that authorized Kmart to pay certain prepetition obligations. For the reasons explained below, the bankruptcy court's orders are reversed.

Appendix B

BACKGROUND

On January 22, 2002, Kmart Corporation and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession (collectively, "Kmart") filed a voluntary petition for reorganization pursuant to Chapter 11 of the United States Bankruptcy Code. As part of its "first day motions" filed on that date, Kmart sought authority to pay prepetition obligations to certain "critical vendors" (the "Critical Vendors Motion") and certain foreign vendors (the "Foreign Vendors Motion"). Kmart contended that these payments were necessary to maintain relationships essential to its continued operation and reorganization, and it invoked the "doctrine of necessity" and 11 U.S.C. § 105(a) for the bankruptcy court's authority to permit these payments.

The same day, the bankruptcy court held a hearing and heard evidence on these motions. Appellant Capital Factors, Inc. ("Capital") objected to both motions. (Capital is a factoring agent[1] for a number of Kmart's apparel suppliers, and it holds general unsecured claims against the bankruptcy estate of approximately $20 million.)

Regarding the Critical Vendors Motion, the court stated:

> Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our

1. A factoring agent purchases accounts receivable from its customers and assumes the collection responsibilities. *See Mr. Furniture Warehouse, Inc. v. Barclays Am./Commercial Inc.*, 919 F.2d 1517, 1519 (11th Cir. 1990).

> problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart's Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors—and I would like a list of the specific vendors that you would like included in this motion—as well as the advertising concerns, are necessary to keep this business going as a going concern.

(App. to Appellee's Brief, Ex. 4A, at 162.) Accordingly, the bankruptcy court granted the Critical Vendors Motion. Without reciting specific findings from the bench, the bankruptcy court also granted the Foreign Vendors Motion. (*Id.* at 173.) On January 25, the bankruptcy court entered written orders granting both motions.

On February 1 and 8, 2002, Kmart filed motions seeking authority to pay issuers of prepetition letters of credit (the "Letters of Credit Motion") and prepetition claims of certain liquor vendors (the "Liquor Vendors Motion"). On February 13, the bankruptcy court held a hearing on these motions, heard evidence, and granted both motions over Capital's objections. Regarding the Letters of Credit Motion, the court stated:

> Because the foreign vendors are integral to the reorganization of this Debtor and the Court already ruled on the payment of certain foreign vendors as part of the critical vendors motions

> and I believe that this is just a component of that particular transaction, and further finding that I may be inconsistent if I do not grant the relief that is requested here, I am going to go ahead and sign your order authorizing the reimbursement of the obligations to the issuers of Letters of Credit.

(*Id.*, Ex. 4B, at 251.) The bankruptcy court also granted the Liquor Vendors motion, "finding that there [was] a good business justification for it." (*Id.* at 269.) Written orders granting the motions were entered that same day.

Capital filed notices of appeal from each order, and we granted Capital's motion to consolidate the appeals. The parties' briefing is complete, and we heard oral argument on the appeals as well.

DISCUSSION

This court has jurisdiction over the instant appeals pursuant to 28 U.S.C. § 158(a)(1). On appeal from an order of the bankruptcy court, we review the bankruptcy court's factual findings under a "clearly erroneous" standard and its conclusions of law *de novo. See In re Smith,* 286 F.3d 461, 464-65 (7th Cir. 2002); Fed. R. Bankr. P. 8013.

Capital raises the following issues on appeal: (1) whether 11 U.S.C. § 105(a) or the "doctrine of necessity" provides a bankruptcy court with either statutory authority or equitable power to allow the payment of selected prepetition unsecured

trade claims prior to confirmation of a Chapter 11 plan;[2] (2) whether there was a sufficient evidentiary basis for the bankruptcy court to allow payment of certain prepetition claims; and (3) whether state laws prohibiting liquor wholesalers from selling products to Chapter 11 debtors legally unable to pay their prepetition debt are invalid or unenforceable to the extent that they conflict with the Bankruptcy Code.[3] Kmart raises the additional issue of whether Capital's appeals are moot because Kmart has already paid a substantial portion of the prepetition claims.

A. *The Bankruptcy Court's Power Under § 105*

We first examine the question of whether the bankruptcy court had the power to authorize the pre-plan payment of prepetition claims. The court relied on 11 U.S.C. § 105(a) to authorize the payments. Section 105(a) addresses the equitable powers of bankruptcy courts and provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the

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2. For convenience, we will refer to the time period prior to confirmation of a Chapter 11 plan as "pre-plan."

3. Capital also raises what it deems a separate issue of whether "a bankruptcy court may utilize" § 105(a) or the "doctrine of necessity" "to circumvent explicit provisions of the Bankruptcy Code." (Appellant's Brief at 2.) We view this issue as being part and parcel of the first issue listed *supra*.

> court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a). Although the bankruptcy court did not refer specifically to the equitable "doctrine of necessity" when ruling on the motions in open court or in its written orders,[4] Kmart relies on the doctrine. It is derived from the "necessity of payment rule," which was developed and used in railroad reorganizations "as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad." *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983). The rule has subsequently evolved into the "doctrine of necessity," which has been applied in non-railroad reorganizations to justify the pre-plan payment of prepetition claims of creditors who threaten to withhold goods or services believed critical to the debtor's continued viability and reorganization.[5] The doctrine is not codified anywhere in the Bankruptcy Code, so the only way to apply it is through § 105.

The Seventh Circuit has stated that the grant of equitable power in § 105 is limited in that it "allows [bankruptcy] courts

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4. As noted *supra*, the bankruptcy court did, however, find that the payments were "necessary," "integral," and that there was "good business justification" for them.

5. See 2 William L. Norton, Jr., *Norton Bankr. L. & Prac. 2d* § 42:11 (Supp. 2002), for a good discussion of the doctrine's history.

to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit." *In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993); *see also Gouveia v. Tazbir*, 37 F.3d 295, 300 (7th Cir. 1994) ("The Supreme Court has taught that any grant of authority given to the bankruptcy courts under § 105 must be exercised within the confines of the bankruptcy code.") (citing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988)).

The Bankruptcy Code sets forth a priority scheme for the payment of claims. *See* 11 U.S.C. §§ 503, 507. The Code does not carve out priority or administrative expense status for prepetition general unsecured claims based on the "critical" or "integral" status of a creditor. But the effect of the bankruptcy court's orders was to elevate the claims of the "critical" vendors over those of other unsecured creditors and to subordinate the claims of non-"critical" unsecured creditors. The bankruptcy court altered the priority scheme set forth in the Bankruptcy Code.

There is a split in the courts regarding whether § 105 authorizes bankruptcy courts to permit pre-plan payment of prepetition unsecured claims. As set forth in Kmart's briefs, many bankruptcy courts and a handful of district courts have held that bankruptcy courts do in fact have this power. *See, e.g., In re Just For Feet, Inc.*, 242 B.R. 821 (D. Del. 1999); *Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.)*, 80 B.R. 279 (S.D.N.Y. 1987); *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re Wehrenberg, Inc.*, 260 B.R. 468 (Bankr. E.D. Mo. 2001).

On the other hand, as Capital points out, a number of courts of appeals and a few lower courts have held just the opposite. *See, e.g., Official Comm. of Equity Sec. Holders v. Mabey,* 832 F.2d 299 (4th Cir. 1987); *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.),* 713 F.2d 534 (9th Cir. 1983); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.),* 4 F.3d 1329 (5th Cir. 1993); *In re FCX, Inc.,* 60 B.R. 405 (E.D.N.C. 1986); *In re Timberhouse Post & Beam, Ltd.,* 196 B.R. 547 (Bankr. D. Mont. 1996).[6] We agree with the latter courts' view that we cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of "equity," especially in light of the Seventh Circuit's admonition that "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.,* 791 F.2d 524, 528 (7th Cir. 1986).

We acknowledge that the application of the "doctrine of necessity" through § 105 in this situation is well-intended and may even have some beneficial results, in that pre-plan payment of certain prepetition claims allows the debtor to minimize disruptions in doing business, and thus may further

6. *Cf. Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.),* 963 F.2d 1490 (11th Cir. 1992) (bankruptcy court had no authority to allow cross-collaterization, a method of securing prepetition debt with prepetition and postpetition collateral); *Southern Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.),* 758 F.2d 137 (3d Cir. 1985) (bankruptcy court had no authority to grant lien status to a prepetition contractual indemnification claim); *Crowe & Assocs., Inc. v. Bricklayers & Masons Union Local No. 2 (In re Crowe & Assocs., Inc.),* 713 F.2d 211, 216 (6th Cir. 1983) (dictum).

reorganization. Nevertheless, it is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.

Because we hold that the bankruptcy court did not have either the statutory or equitable power to authorize the pre-plan payment of prepetition unsecured claims, we need not address the second and third issues Capital raises on appeal.

B. ***"Equitable Mootness"***

Kmart does not persuade us that Capital's appeals are moot due to the fact that the prepetition claims have been substantially paid. Kmart makes much of the fact that Capital did not seek a stay of the bankruptcy court's orders. It is highly unlikely, however, that a motion to stay would have been successful. It would be inconsistent for the bankruptcy court to enter the orders on the theory that prompt payments were necessary to keep Kmart operational, and then turn around and stay those orders.[7] In any event, Capital was not required to seek a stay of the orders in order to preserve its appellate rights.

Kmart also argues that the appeals are "equitably moot" because effective relief on appeal has become imprudent and inequitable. The term "equitable mootness"

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7. *See* Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations,* 65 Am. Bankr. L.J. 75, 108 (1991).

was "anathematized by Judge Easterbrook"[8] in the case of *In re UNR Industries, Inc.*, 20 F.3d 766, 768 (7th Cir. 1994). The Seventh Circuit in *UNR* "banish[ed] the term 'equitable mootness' from the (local) lexicon," 20 F.3d at 769, because it is misleading: "[t]here is a big difference between *inability* to alter the outcome (real mootness) and *unwillingness* to alter the outcome ('equitable mootness')." *Id.* Nonetheless, the "now nameless doctrine" lives on and "is perhaps best described as merely an application of the age-old principle that in formulating equitable relief a court must consider the effects of the relief on innocent third parties." *Envirodyne*, 29 F.3d at 304. The basic questions under the doctrine, then, are these: is it prudent and fair to undo what the bankruptcy court did?[9] *See UNR*, 20 F.3d at 769; *Envirodyne*, 29 F.3d at 304.

Kmart argues that we should not reverse the orders allowing payment of the prepetition claims because the parties receiving the payments have already acted in reliance on them. As noted *supra* note 9, however, this is not a situation where there has been confirmation of a bankruptcy plan. Accordingly, it is not too late to order that the monies paid be returned. Kmart also claims that undoing the

8. *In re Envirodyne Indus., Inc.*, 29 F.3d 301, 304 (7th Cir. 1994).

9. As Capital points out, it is worth noting that most of the cases addressing or applying the doctrine involved appeals of orders confirming bankruptcy plans of reorganization. *See, e.g., UNR*, 20 F.3d 766; *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622 (4th Cir. 2002). Those cases are distinguishable from the instant proceeding because there has not yet been a confirmation of Kmart's plan.

bankruptcy court's orders would "paralyze" Kmart by forcing it to "undergo the Herculean task of immediately commencing thousands of lawsuits to collect hundreds of millions of dollars from thousands of vendors." (Appellee's Brief at 45-46.) We are not persuaded by Kmart's doomsday speculations. It is not evident that Kmart will have to sue to recover the payments, and in fact, Kmart cites no cases indicating that the bankruptcy court would not have the power to order the return of the monies paid.

C. *J.P. Morgan Chase's Brief*

J.P. Morgan Chase ("JPM"), which is an "administrative agent for the lenders under various pre-petition credit agreements among such lenders and Kmart" (JPM Brief at 1), has filed a supplemental brief regarding the Letters of Credit Motion. JPM contends that, even if the bankruptcy court did not have the authority under § 105 to authorize Kmart to pay the prepetition claims of the issuers of the letters of credit, the court "properly allowed those payments [pursuant to § 361 of the Bankruptcy Code] on the basis that such payments constituted adequate protection for the Issuers' secured reimbursement claims under the Letters of Credit." (JPM Brief at 2.) According to JPM, the issuers had statutory liens in the documents and the proceeds thereof presented by the foreign vendors to obtain payment under the letters of credit, and the issuers were entitled to adequate protection of those liens under § 361 of the Code.[10]

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10. Section 361 provides:

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(Cont'd)

Appendix B

In authorizing the payments to the issuers of the letters of credit, the bankruptcy court did not rely on § 361. We may affirm the bankruptcy court's decision on an alternative ground, but that ground must have been adequately presented in the bankruptcy court. *See Anderson v. U.S.F. Logistics (IMC), Inc.*, 274 F.3d 470, 478 (7th Cir.2001) (citing *Logan v. Caterpillar, Inc.*, 246 F.3d 912, 924 (7th Cir.2001)). Neither Kmart nor the issuers raised the adequate protection issue at the hearing on the Letters of Credit Motion. The bankruptcy court was not presented with evidence on whether the issuers held valid security interests nor whether they were entitled to adequate protection. There is an insufficient basis in the record to allow a finding that the payments to the issuers constituted adequate protection under § 361 of the Bankruptcy Code.

(Cont'd)

> 1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
>
> 2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
>
> 3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

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CONCLUSION

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Liquor Vendors.

The case is remanded for further proceedings consistent with this opinion.

Docket Entry No. 37 (in No. 02–1264)

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105 (a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of

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Prepetition Claims of Certain Liquor Vendors. The case is remanded for further proceedings consistent with this opinion.

Appellant's motion for an expedited ruling is denied as moot.

APPENDIX C — ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED JANUARY 25, 2002

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Chief Judge Susan Pierson Sonderby

In re:

KMART CORPORATION, et al.,

Debtors.

ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Upon the motion dated January 22, 2002 (the "Motion"), wherein Kmart Corporation ("Kmart") and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession in the above-captioned cases (collectively, the "debtors" or the "Company"), moved this Court for entry of an order, pursuant to section 105(a) authorizing the Debtors to pay Critical Vendor Claims; it appearing to the Court that (i) it has jurisdiction over the matters raised in the Motion

pursuant to 28 U.S.C. §§ 157 and 1334; (ii) this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); (iii) the relief requested in the Motion is in the best interests of the Debtors, their estates and their creditors; (iv) proper and adequate notice of the Motion and the hearing thereon has been given and that no other or further notice is necessary; and (v) upon the record herein, including the exhibits attached to the Notice of Filing of Exhibits as Ordered by the Court at the January 22, 2002 Hearing, filed on or about January 25, 2002, after due deliberation thereon, the relief should be granted as set forth below,

1. The Debtors are authorized, but not directed, in the reasonable exercise of their business judgment, to pay all, a portion or none of the prepetition claims (the "Critical Vendor Claims") of the following "Critical Vendors": (a) Fleming Companies, Inc.; (b) Handleman Company; (c) vendors who supply egg and dairy and (d) certain newspapers, printers, paper suppliers and other vendors who supply goods and services related to the Debtors' advertising program. The payment of the Critical Vendor Claims shall not exceed those set forth in the Motion upon such terms and in the manner provided in this Order and subject to the provisions of the Debtors' postpetition financing agreement.

2. Any checks used by the Debtors to pay Critical Vendor Claims shall contain a legend substantially in the following form:

> By accepting this check, the payee agrees to the terms of that certain Order of the United States Bankruptcy Court for the Northern District of

Illinois, dated as of _____, in the payor's chapter 11 case (Case No. _____), entitled "Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors," (including, if applicable, any Trade Agreement entered into pursuant to that Order) and submits to the jurisdiction of that Court for enforcement thereof.

3. The Debtors shall undertake appropriate efforts to cause Critical Vendors to enter into an agreement with the Debtors as provided herein as a condition of payment of their Critical Vendor Claims, which agreement shall include the following terms:

(a) The amount of such Critical Vendor's estimated Critical Vendor Claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Vendor and the Debtors (but such amount shall be used only for the purposes of determining such Critical Vendor's claim under this Order and shall not be deemed a claim allowed by the Court and the rights of all interested persons to object to such claim shall be fully preserved until further order of this Court);

(b) The Customary Trade Terms between such Critical Vendor and the Debtors, or such other terms as the Critical Vendors and the Debtors may agree;

(c) The Critical Vendor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such other favorable terms as the Debtors

and the Critical Vendor may otherwise agree, for a period at least two (2) years from the Petition Date, and the Debtors' agreement to pay in accordance with such terms;

(d) The Critical Vendor's agreement not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (a "Lien"), regardless of the statute or other legal authority upon which such Lien is asserted, related in any way to any remaining prepetition amounts allegedly owed to the Critical Vendor by the Debtors arising from agreements or other arrangements entered into prior to the Petition Date, and, to the extent the Critical Vendor has already obtained or otherwise asserted such a Lien, the Critical Vendor shall take whatever actions are necessary to remove such Lien;

(e) The Critical Vendor's acknowledgment that it has reviewed the terms and provisions of this Order and consents to be bound hereby; and

(f) The Critical Vendor's agreement that it will not separately seek payment for reclamation claims outside the terms of this Order unless the Critical Vendor's participation in the program to pay Critical Vendor Claims pursuant to this Order is terminated; *provided*, *however*, that such reclamation claims shall, if thereafter raised by the Critical Vendor as permitted by this Order, be treated as though raised on the date of this Order.

An agreement executed by and between the Debtors and a Critical Vendor as set forth in this paragraph shall be referred

to as a "Trade Agreement." This order is intended to authorize, but shall not require, the Debtors to enter in to Trade Agreements, it being the express intention of this Court that the Debtors shall enter into Trade Agreements only when the Debtors determine, in the exercise of their reasonable business judgment, that it is appropriate to do so.

4. The Debtors are authorized, in their discretion to make payments on account of Critical Vendor Claims in the absence of a Trade Agreement after the Debtors have undertaken diligent efforts to cause the Critical Vendor holding such Critical Vendor Claim to execute a Trade Agreement and if the Debtors determine, in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors' business operations.

5. If a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, or fails to comply with any Trade Agreement entered into between such Critical Vendor and the Debtors, then the Debtors may, in their discretion and without further order of the Court, (a) declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding post-petition claims of such vendors without further order of the Court or action by any person or entity, and, to the extent that payments on account of such Critical Vendor Claims exceed the postpetition claims of such vendors then outstanding without giving effect to any rights of setoff, claims, provision for

payment of reclamation or trust fund claims, or otherwise. In the event a Trade Agreement is terminated or a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, it is the explicit intention of this Court to return the parties to their position immediately prior to the entry of the order approving this Motion with respect to all prepetition claims.

6. The Debtors may, in their sole discretion, reinstate a Trade Agreement if:

(a) Such determination is subsequently reversed by the Court, after notice and a hearing following a motion by the Critical Vendor, for good cause shown that the determination was materially incorrect;

(b) The underlying default under the Trade Agreement was fully cured by the Critical Vendor not later than five (5) business days following the Debtors' notification to the Critical Vendor that a default had occurred; or

(c) The Debtors, in their discretion, reach a favorable alternative agreement with the Critical Vendor.

7. Nothing herein shall be construed to limit, or in any way affect, the Debtors' ability to dispute any Critical Vendor Claim.

8. Nothing contained in this order shall be deemed to constitute an assumption or rejection of any executory contract or agreement between the Debtors and a Critical

Vendor or to require the Debtors to make any of the payments authorized herein.

9. Notwithstanding the relief granted herein and any actions taken hereunder, nothing contained herein shall create, nor is it intended to create, any rights in favor of, or enhance the status of any claim held by, any person.

10. This Court shall retain jurisdiction to construe and enforce this Order.

Dated: Chicago, Illinois
January 25, 2002

/s/ Susan Pierson Sonderby
Chief Judge Susan Pierson Sonderby
UNITED STATES BANKRUPTCY JUDGE

APPENDIX D — NOTICE OF APPEAL FROM ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIISION DATED FEBRUARY 1, 2002

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

[Filed Feb. 1, 2002]

Chapter 11
No. 02 B 02474 (Jointly Administered)
Hon. Susan Pierson Sonderby.

IN RE: KMART CORPORATION, *et al.*,

Debtors.

NOTICE OF APPEAL FROM ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Pursuant to 28 U.S.C. § 158(a), Capital Factors, Inc. ("Capital") appeals from an order dated January 25, 2002, entitled "Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors," a copy of which is annexed hereto as Exhibit A and incorporated herein by this reference. A list of names of all parties known to Capital that have filed appearances or

requests for notice in these jointly administered chapter 11 cases is annexed hereto as Exhibit B and incorporated herein by this reference.

Respectfully submitted,

Capital Factors, Inc.
By: /s/ Steven B. Towbin
One of its attorneys

Dated: February 1, 2002

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APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DENYING PETITION FOR REHEARING DATED MAY 6, 2004

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

May 6, 2004

Before

Hon. FRANK H. EASTERBROOK, Circuit Judge

Hon. DANIEL A. MANION, Circuit Judge

Hon. ILANA DIAMOND ROVNER, Circuit Judge

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

Nos. 02 C 1264
02 C 1265
02 C 2086
02 C 2088
John F. Grady, *Judge*

Appendix E

Nos. 03-2262, 03-2346, 03-2347 & 03-2348

In the matter of:

KMART CORPORATION,

Debtor-Appellant.

Appeal of:

IRVING PULP & PAPER, LIMITED,
doing business as IRVING PAPER

Order

Irving Pulp & Paper, Limited d/b/a Irving Paper filed a petition for rehearing and rehearing en banc on March 9, 2004. No judge in regular active service has requested a vote on the petition for rehearing en banc,* and all of the judges on the panel have voted to deny rehearing. The petition for rehearing is therefore DENIED.

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* Chief Judge Flaum did not participate in the consideration of this petition.

APPENDIX F — EXCERPTS FROM MOTION FOR ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Hon. Sonderby
Hearing Date: January 22, 2002
Hearing Time: 4:00 PM

In re:

KMART CORPORATION, *et al.*,

Debtors.

MOTION FOR ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Kmart Corporation ("Kmart") and 37 of its subsidiaries and affiliates (the "Affiliate Debtors"), debtors and debtors-in-possession in the above-captioned cases (collectively, the "Debtors" or the "Company"), hereby move (the "Motion") this Court for an order, pursuant to section 105(a) of chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code"), authorizing the payment of prepetition claims of certain

critical trade vendors. In support of this Motion, the Debtors rely on the Affidavit of Charles C. Conaway, in Support of Chapter 11 Petitions and First Day Orders, sworn to on January 22, 2002. In further support of this Motion, the Debtors respectfully represent as follows:

BACKGROUND

A. *The Chapter 11 Filings*

* * *

1. On January 22, 2002 (the "Petition Date"), the Debtors filed a voluntary petition in this Court for reorganization relief under chapter 11 of the Bankruptcy Code. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1109 of the Bankruptcy Code. The Debtors have moved this Court for an order for joint administration of these chapter 11 cases. None of Kmart's international subsidiaries locate outside of the United States have filed for reorganization or insolvency protection in any jurisdiction and each continues to operate in the ordinary course of business.

2. No creditor's committee has yet been appointed in these cases. No trustee or examiner has been appointed.

3. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

4. The statutory predicates for the relief sought herein are section 105(a) of the Bankruptcy Code.

B. *Background and Current Business Operations*

5. Kmart is ranked number 36 on Fortune's list of 500 companies and is a member of the Fortune Global 100. It is the successor to the business developed by its founder, S.S. Kresge, who opened his first store in 1899. The first store using the Kmart name was opened in March 1962. Since that time, Kmart has become the nation's second largest discount retailer and the third largest general merchandise retailer. Approximately 75% of the U.S. population shops at Kmart each year and about 85% of the U.S. population presently lives within 15 miles of a Kmart store.

6. Kmart has approximately 240,525 associates worldwide and is one of the top twelve employers in the United States with approximately $5.2 billion in annual payroll and benefits. Kmart has relationships with more than 4,000 vendors worldwide and is one of the country's largest purchasers of products.

7. Kmart is focusing its merchandising and marketing approach on strengthening its brand positioning, pricing strategies, presentation and productivity to build customer loyalty and increase shopping frequency. Kmart aims to become the destination for what moms value by being her authority for her home and kids. It intends to do so by featuring popular national brands at competitive prices combined with new, distinct brands to differentiate itself in the marketplace. Kmart is continually growing its exclusive

private brand product offerings, which is highlighted by recent agreements with nationally recognized names, such as Joe Boxer, Disney and an extended contract for the exclusive sale of Martha Stewart home and garden products. Other high quality private brand collections available exclusively at Kmart include: Jaclyn Smith, Route 66 apparel, as well as Thom McAnn shoes, White Westinghouse appliances, Penske automotive products and BestYet.

* * *

RELIEF REQUESTED

14. By this Motion, the Debtors seek entry of an order authorizing, but not requiring, them to pay, in the reasonable exercise of their business judgment, the prepetition claims of certain critical vendors that are essential to the uninterrupted functioning of the Debtors' business operations, namely: (i) Fleming Companies, Inc. ("Fleming"), (ii) Handleman Company ("Handleman"), (iii) vendors who supply egg and dairy and (iv) certain newspapers, printers, paper suppliers and other vendors who supply goods and services related to the Debtors' advertising program (the "Critical Vendors", whose prepetition claims shall be identified as "Critical Vendor Claims"). Payment of the Critical Vendor Claims is vital to the Debtors' reorganization efforts, as (a) the goods and services provided by the Critical Vendors are often the only source from which the Debtors can procure certain goods or services, (b) failure to pay the Critical Vendor Claims would, in the business judgment of the Debtors, very likely result in the Critical Vendors terminating their provision of goods and/or services to the

Debtors, and/or (c) the Critical Vendors would themselves be irreparably damaged by the Debtors' failure to pay their prepetition claims, resulting in the Debtors being forced to try to obtain goods and services elsewhere that would either not be available, be at a higher price, at unfavorable terms to the Debtors, or not of the quality required by the Debtors. In addition, some of the specific Critical Vendors provide not only merchandise but also indispensable infrastructure and support to certain of the Debtors' store operations.

Fleming

15. Fleming is a food distribution company that provides substantially all of the food and consumable products in the Debtors' stores. Fleming is the Debtors' single largest supplier accounting for 11%, or $4.2 billion, of total sales by the Debtors on an annual basis. Fleming not only supplies the Debtors with merchandise but also provides the infrastructure for the Debtors' Food and Consumable operations, including buying and procuring merchandise, warehousing operations, transportation and logistics, and vendor allowance collection management. Cessation of these services would quickly result in a severe sales impact given the speed at which this type of inventory turns and the overall impact extreme out-of-stock levels would have on shoppers' willingness to shop at the Debtors' stores. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $76 million to Fleming.

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Handleman

16. Handleman is the Debtors' sole music vendor, accounting for 1.5%, or $500 million, of total sales by the Debtors on an annual basis. Handleman not only supplies merchandise but also provides the infrastructure for the Debtors' music business. The product offering in the music department is unusually complex due to the number of different specific products offered and geographic sensitivity as it relates to music tastes. Handleman's employees fundamentally run the music department in each of the Debtors' stores in that they place merchandise orders for the stores, stock shelves, set up displays for new music releases, and operate the merchandise return process. Without Handleman, the Debtors would not be able to operate the infrastructure required to generate music sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $64 million to Handleman.

Egg and Dairy Vendors

17. The Debtors' supplier base for egg and dairy vendors is primarily composed of small vendors who are highly dependent on cash flow. Egg and dairy sales account for approximately 0.5%, or $160 million of total sales by the Debtors on an annual basis. Given the perishable nature of the product, the egg and dairy vendors directly stock the store on a daily basis. Without this support, the stores would be completely out of stock of this merchandise within two days. Further, approximately 8% of all shoppers purchase this merchandise category on a given shopping trip to the Debtors' stores. Without this product category, shoppers will be less likely to choose Kmart for their daily shopping needs, thus severely impacting the Debtors' overall sales. The Debtors

estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $6.8 million to egg and dairy vendors.

Advertising

18. The Debtors' weekly sales volume is highly dependent on their weekly newspaper circular program. Approximately 30%, or $11 billion of total sales are generated via advertised items. The Debtors print approximately 78 million circulars each week. These circulars are distributed nationally via newspapers to the Debtors' markets. Continuation of the entire circular advertising program, including circular layout and development, commodity paper procurement, circular printing, and newspaper placement and distribution, is critical to the ongoing health of the business. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $37 million to newspapers, ad production business, printers, and commodity paper suppliers.

A. Proposed Terms and Conditions of Payment of Critical Vendor Claims

19. The Debtors hereby request authorization to pay all, a portion or none of the Critical Vendor Claims as determined by the Debtors in their sole discretion in or to continue the vital goods and services provided by the Critical Vendors. The Debtors propose to condition the payment of Critical Vendor Claims on the agreement of individual Critical Vendors to continue supplying goods and services to the Debtors on the trade terms that such Critical Vendor provided

goods and/or services to the Debtors on a historical basis prior to the Petition Date (the "Customary Trade Terms"), or such other favorable trade practices and programs that are at least as favorable to the Debtors as those in effect during such time. The Debtors reserve the right to negotiate new trade terms with any Critical Vendor as a condition to payment of any Critical Vendor Claim.

20. To ensure that the Critical Vendors deal with the Debtors on Customary Trade Terms, the Debtors propose that (a) a letter substantially in the form of the letter attached hereto as *Exhibit A* be sent to the Critical Vendors along with a copy of the Order granting this Motion, and (b) the checks used to pay Critical Vendor Claims contain a legend substantially in the following form:

> By accepting this check, the payee agrees to the terms of that certain Order of the United States Bankruptcy Court for the Northern District of Illinois, dated as of _____, in the payor's chapter 11 case (Case No. _____), entitled "Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors," (including, if applicable, any Trade Agreement entered into pursuant to that Order) and submits to the jurisdiction of that Court for enforcement thereof.

21. The Debtors propose that the letter sent to Critical Vendors shall include, but not be limited to, the following terms:

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(a) The amount of such Critical Vendor's estimated Critical Vendor Claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Vendor and the Debtors (but such amount shall be used only for the purposes of determining such Critical Vendor's claim under this Order and shall not be deemed a claim allowed by the Court and the rights of all interested persons to object to such claim shall be fully preserved until further order of this Court);

(b) The Customary Trade Terms between such Critical Vendor and the Debtors, or such other terms as the Critical Vendors and the Debtors may agree and the Critical Vendor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such other favorable terms as the Debtors and the Critical Vendor may otherwise agree;

(c) The Critical Vendor's agreement not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (a "Lien"), regardless of the statute or other legal authority upon which such Lien is asserted, related in any way to any remaining prepetition amounts allegedly owed to the Critical Vendor by the Debtors arising from agreements or other arrangements entered into prior to the Petition Date, and, to the extent the Critical Vendor has already obtained or otherwise asserted such a Lien, the Critical Vendor shall take whatever actions are necessary to remove such Lien;

(d) The Critical Vendor's acknowledgment that it has reviewed the terms and provisions of this Order and consents to be bound hereby; and

(e) The Critical Vendor's agreement that it will not separately seek payment for reclamation claims outside the terms of this Order unless the Critical Vendor's participation in the program to pay Critical Vendor Claims pursuant to this Order is terminated; *provided*, *however*, that such reclamation claims shall, if thereafter raised by the Critical Vendor as permitted by this Order, be treated as though raised on the date of this Order.

Such a letter, once agreed to and accepted by a Critical Vendor, shall be referred to herein as a "Trade Agreement."

22. By this Motion, the Debtors seek only the authority to enter into Trade Agreements, when the Debtors determine in their discretion that such an agreement is necessary, and not to be required to do so. The Debtors seek authority, to make payments on account of such Critical Vendor's claims, notwithstanding the fact that following diligent efforts to enter into a Trade Agreement with a Critical Vendor, no Trade Agreement has been reached, if the Debtors determine, in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors' business operations.

23. For those Critical Vendors who have agreed to ship goods or render services on trade terms other than their Customary Trade Terms, the Debtors reserve the right to obtain written acknowledgment of such terms on a

case-by-case basis. Nothing in this Motion should be construed as a waiver by any of the Debtors of their rights to contest any invoice of a Critical Vendor under applicable non-bankruptcy law.

24. If a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, or fails to comply with any Trade Agreement entered into between such Critical Vendor and the Debtors, then the Debtors seek authority, in their discretion and without further order of the Court, (a) to declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) to declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding postpetition claims of such vendors without further order of the Court or action by any person or entity. In the event that such events occur, a Critical Vendor shall then immediately repay to the Debtors any payment made to it on account of its Critical Vendor Claims to the extent that payments on account of such Critical Vendor Claims exceed the postpetition claims of such vendors then outstanding without giving effect to any rights of setoff, claims, provision for payment of reclamation or trust fund claims, or otherwise. In sum, the Debtors seek to return the parties to their position immediately prior to the entry of the Order approving this Motion with respect to all prepetition claims in the event a Trade Agreement is terminated or a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim.

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25. The Debtors further propose that any Trade Agreement terminated as a result of a Critical Vendor's refusal to comply with the terms thereof may be reinstated if:

(a) such determination is subsequently reversed by the Court, after notice and a hearing following a motion by the Critical Vendor, for good cause shown that the determination was materially incorrect;

(b) the underlying default under the Trade Agreement was fully cured by the Critical Vendor not later than five (5) business days following the Debtors' notification to the Critical Vendor that a default had occurred; or

(c) the Debtors, in their discretion, reach a favorable alternative agreement with the Critical Vendor.

26. Some of the Critical Vendors also may have obtained mechanics' liens, possessory liens, or other similar state law trade liens ("Trade Liens") on the Debtors' assets, based upon Critical Vendor Claims held by such vendors. As a further condition of receiving payment on a Critical Vendor Claim, a Critical Vendor must agree to take whatever action is necessary to remove the Trade Lien at such Critical Vendor's sole cost and expense.

B. Payment of the Critical Vendor Claims Is Necessary for the Debtors' Successful Reorganization in These Chapter 11 Cases

27. The Debtors believe that payment of the Critical Vendor Claims is necessary to effect their successful reorganization in these cases. If the Motion is not granted, the Critical Vendors are likely to discontinue providing goods to the Debtors on Customary Trade Terms, effectively reducing the amount of credit available to the Debtors. Moreover, the Debtors believe that certain of the Critical Vendors might cease to do business with the Debtors altogether, resulting in the Debtors' inability to obtain certain essential goods and services and forcing the Debtors to incur higher costs. As detailed further below, such actions would be harmful if not devastating to the Debtors, their estates and creditors.

28. The continued availability of trade credit in amounts and on terms consistent with those enjoyed by the Debtors prepetition is clearly of benefit to the Debtors in that it will permit them to maintain liquidity for their business operations. The Debtors believe that preserving working capital through the retention or reinstatement of traditional trade credit terms will enable them to maintain their competitiveness and maximize the value of their business, for the benefit of the Debtors, their estates and creditors. Conversely, a deterioration of trade credit and a disruption or cancellation in the delivery of goods or provision of services -- many of which are not readily replaceable -- would cripple the Debtors' business operations, increase the amount of funding needed by the Debtors postpetition, and ultimately hamper the Debtors' ability to service their customers, whose continued loyalty is vital to the successful reorganization of the Debtors' business.

29. In addition, the relief requested herein, if granted, will likely avert the filing of countless reclamation claims, suits, liens and motions by claimants seeking payment of or priority for their claims on a variety of grounds. Avoiding the time, distraction and considerable expense of litigating the merits of such claims will benefit the Debtors, their estates and creditors while facilitating the administration of these cases.

* * *

WHEREFORE the Debtors respectfully request that the Court enter an order (i) authorizing the Debtors to pay the Critical Vendor Claims, subject to the availability as may be permitted pursuant to the Debtors' postpetition financing agreement, and (ii) granting the Debtors such other and further relief as is just and proper.

Dated: Chicago, Illinois
January 12, 2002

Respectfully Submitted,

By: s/ J. Eric Ivester
John Wm. Butler, Jr. (ARDC No. 06209373)
J. Eric Ivester (ARDC No. 06215581)
SKADDEN, ARPS, SLATE, MEAGHER
& FLOM (ILLINOIS)
333 West Wacker Drive, Suite 2100
Chicago, Illinois 60606-1285
(312) 407-0501

Attorneys for Debtors and
Debtors-in-Possession

Appendix F

EXHIBIT A

_____, 2002

To: [Essential Trade Creditor]
[Name]
[Address]

Dear Valued Supplier:

As you are no doubt aware, on _____, 2002 (the "*Petition Date*"), [Debtor], together with certain of its U.S. affiliates (collectively, the "*Debtors*"), filed voluntary petitions under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of Illinois (the "*Bankruptcy*" and the "*Bankruptcy Court*," respectively). On the Petition Date, we requested the Bankruptcy Court's authority to pay certain suppliers in recognition of the importance of our relationship with such suppliers and our desire that the Bankruptcy Cases have as little effect on them as possible. On _____, 2002, the Bankruptcy Court entered an order (the "*Order*") authorizing us, under certain conditions, to pay pre-bankruptcy claims of certain trade creditors that agree to the terms set forth below and to be bound by the terms of the Order. A copy of the Order is enclosed.

In order to receive payment on pre-bankruptcy claims, each selected trade creditor must agree to continue supplying goods to the Debtors based on "*Customary Trade Terms*." In the Order, Customary Trade Terms are defined as the normal and customary trade terms, practices and programs

(including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowance, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs) in effect between such trade creditor and the Debtors on a historical basis prior to the Petition Date or such other trade terms, practices and programs that are at least as favorable to the Debtors as those in effect during such time.

For purposes of administration of this trade program as authorized by the Bankruptcy Court, the Debtors and you agree as follows:

1. The estimated balance of the prepetition trade claim (net of any setoffs, credits or discounts (the "*Trade Claim*") that the Debtors will provisionally pay you is $

2. You will provide open credit terms as follows (if more space is required, attach continuation pages)

3. The open trade balance or credit line that you will extend to the Debtors for shipment of postpetition goods is $ _____3 (which shall not be less than the greater of the open trade balance outstanding: (a) on _____, 2002, or (b) on normal and customary terms on a historical basis for the period prior to the Petition Date).

4. In consideration for the payment described herein, you agree not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (regardless of the statute or other legal authority upon

which such lien is asserted) related in any way to any remaining prepetition amounts allegedly owed to you by the Debtors arising from agreements entered into prior to the Petition Date. Furthermore, if you have taken steps to file or assert such a lien prior to entering into this letter agreement, you agree to take all necessary steps to remove such lien as soon as possible.

5. You will hereafter extend to the Debtors all Customary Trade Terms (as defined in the Order).

Payment of your Trade Claim in the manner set forth in the Order may only occur upon execution of this letter by a duly authorized representative of your company and the return of this letter to the Debtors. Your execution of this letter agreement anti return of the same to the Debtors constitutes an agreement by you and the Debtors:

(a) to the Customary Trade Terms and, subject to the reservations contained in the Order, to the amount of the Trade Claim set forth above;

(b) that, for a period of no less that two (2) years from the Petition Date, you will continue to supply the Debtors with goods, pursuant to the Customary Trade Terms and that the Debtors will pay for such goods in accordance with Customary Trade Terms;

(c) that you have reviewed the terms and provisions of the Order and that you consent to be bound by such teams;

(d) that you will not separately seek payment for reclamation and similar claims outside of the terms of the Order unless your participation in the trade payment program authorized by the Order (the "*Trade Payment Program*") is terminated; and

(e) that if either the Trade Payment Program or your participation therein terminates as provided in the Order, any payments received by you on account of your Trade Claim will be deemed to have been in payment of then outstanding postpetition obligations owed to you and that you will immediately repay to the Debtors any payments made to you on account of your Trade claim to the extent that the aggregate amount of such payments exceed the postpetition obligations then outstanding without the right of any setoffs, claims, provision for payment of reclamation or trust fund claims, or otherwise.

The Debtors and you also hereby agree that any dispute with respect to this agreement, the Order and/or your participation in the Trade Payment Program shall be determined by the Bankruptcy Court.

If you have any questions about this Agreement or our financial restructuring, please do not hesitate to call (__) _____ or (__) _____.

Sincerely,

[Debtor]

By:

Its:

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Agreed and Accepted by:
[Name of Trade Vendor]

By:

Its:

Dated:

APPENDIX G — EXCERPTS FROM AFFIDAVIT AND STATEMENT OF CHARLES C. CONAWAY IN SUPPORT OF CHAPTER 11 PETITIONS AND FIRST DAY ORDERS FILED JANUARY 25, 2002

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Hon. Sonderby
Hearing Date: January 22, 2002
Hearing Time: 4:00 PM

In re:

KMART CORPORATION, *et al.*,

Debtors.

AFFIDAVIT AND STATEMENT OF CHARLES C. CONAWAY IN SUPPORT OF CHAPTER 11 PETITIONS AND FIRST DAY ORDERS

STATE OF ILLINOIS)
) ss:
COUNTY OF COOK)

I, Charles C. Conaway, being duly sworn, deposes and says:

Appendix G

1. I am the Chief Executive Officer of Kmart Corporation ("Kmart"), a corporation organized under the laws of the State of Michigan. The other debtors are: Kmart Corporation of Illinois, Inc.; Kmart of Indiana; Kmart of Pennsylvania LP; Kmart of Texas L.P.; Kmart of North Carolina LLC; Big Beaver of Florida Development, LLC; Bluelight.com LLC; Kmart Michigan Property Services, L.L.C.; TC Group I LLC; Troy CMBS Property, L.L.C.; Kmart Financing I; Big Beaver Development Corporation; Big Beaver of Caguas Development Corporation; Big Beaver of Guaynabo Development Corporation; BlueLight.com. Inc.; Kmart Holdings, Inc.; Kmart of Amsterdam, NY Distribution Center, Inc.; Kmart Stores of Indiana, Inc.; Kmart of Michigan, Inc.; Kmart Stores of TNCP, Inc.; Kmart Overseas Corporation; JAF, Inc.; VTA, Inc.; Big Beaver of Caguas Development Corporation II; Big Beaver of Carolina Development Corporation; Kmart Pharmacies, Inc.; Kmart Pharmacies of Minnesota, Inc.; Builders Square, Inc., Kmart CMBS Financing, Inc.; K mart International Services, Inc.; PMB, Inc.; Sourcing & Technical Services Inc.; ILJ, Inc.; STI Merchandising, Inc.; KBL Holding Inc.; KLC, Inc.; and S.F.P.R, Inc. (such debtors, the "Affiliate Debtors" and, together with Kmart, the "Debtors" or the "Company"). In addition to being the Chief Executive Officer of Kmart, I hold executive positions within or am an authorized representative of, each of the Affiliate Debtors. The Company's principal executive offices are located at 3100 West Big Beaver Road, Troy, MI 48084-3163.

2. I have been associated with the Company since 2000 and am familiar with the Company's day-to-day operations, business-affairs, and books and records. In recent weeks,

Appendix G

I have participated in the Company's discussions with potential debtor-in-possession ("DIP") lenders and am familiar with the existing credit facilities and the proposed DIP Credit Agreement. In my capacity as Chief Executive Officer, I am familiar with the Company's day-to-day operations, business affairs, and books and records.

3. I submit this affidavit in support of the first-day applications and motions in the above-captioned chapter 11 cases. Any capitalized term not expressly defined herein shall have the meaning ascribed to that term in the relevant first-day motion or application. Except as otherwise indicated, all facts set forth in this affidavit are based upon my personal knowledge, my review of relevant documents, or my opinion, based upon my experience and knowledge of the Company's operations and financial condition. If I were called upon to testify, I could and would testify competently to the facts set forth herein. I am authorized to submit this affidavit.

4. Part I of this affidavit describes the Company's business and the circumstances surrounding the filing of the Company's chapter 11 petitions. Part II sets forth the relevant facts in support of the Company's various first-day applications and papers filed concurrently herewith.

Appendix G

I. *BACKGROUND*

A. *The Chapter 11 Filings*

5. On January 22, 2002 (the "Petition Date"), the Debtors filed a voluntary petition in this Court for reorganization relief under chapter 11 of the Bankruptcy Code. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1109 of the Bankruptcy Code. The Debtors have moved this Court for an order for joint administration of these chapter 11 cases. None of Kmart's international subsidiaries located outside of the United States have filed for reorganization or insolvency protection in any jurisdiction and each continues to operate in the ordinary course of business. In order to enable the Company to operate effectively and to avoid the adverse effects of the chapter 11 filings, the Company will request various types of relief in "first-day" applications and motions filed with the Court.

* * *

Critical Prepetition Trade Vendors

183. Payment of the Critical Vendor Claims is vital to the Debtors' reorganization efforts, as (a) the goods and services provided by the Critical Vendors are often the only source from which the Debtors can procure certain goods or services, (b) failure to pay the Critical Vendor Claims would, in the business judgment of the Debtors, very likely result in the Critical Vendors terminating their provision of goods and/or services to the Debtors, and/or (c) the Critical Vendors

would themselves be irreparably damaged by the Debtors' failure to pay their prepetition claims, resulting in the Debtors being forced to try to obtain goods and services elsewhere that would either not be available, be at a higher price, at unfavorable terms to the Debtors, or not of the quality required by the Debtors. In addition, some of the specific Critical Vendors provide not only merchandise but also indispensable infrastructure and support to certain of the Debtors' store operations.

Fleming

184. Fleming is a food distribution company that provides substantially all of the food and consumable products in the Debtors' stores. Fleming is the Debtors' single largest supplier accounting for 11%, or $4.2 billion, of total sales by the Debtors on an annual basis. Fleming not only supplies the Debtors with merchandise but also provides the infrastructure for the Debtors' Food and Consumable operations, including buying and procuring merchandise, warehousing operations, transportation and logistics, and vendor allowance collection management. I believe that cessation of these services would quickly result in a severe sales impact given the speed at which this type of inventory turns and the overall impact extreme out-of-stock levels would have on shoppers' willingness to shop at the Debtors' stores. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $76 million to Fleming.

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Handleman

185. Handleman is the Debtors' sole music vendor, accounting for 1.5%, or $500 million, of total sales by the Debtors on an annual basis. Handleman not only supplies merchandise but also provides the infrastructure for the Debtors' music business. The product offering in the music department is unusually complex due to the number of different specific products offered and geographic sensitivity as it relates to music tastes. Handleman's employees fundamentally run the music department in each of the Debtors' stores in that they place merchandise orders for the stores, stock shelves, set up displays for new music releases, and operate the merchandise return process. I believe that without Handleman, the Debtors would not be able to operate the infrastructure required to generate music sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $64 million to Handleman.

Egg and Dairy Vendors

186. The Debtors' supplier base for egg and dairy vendors is primarily composed of small vendors who are highly dependent on cash flow. Egg and dairy sales account for approximately 0.5%, or $160 million of total sales by the Debtors on an annual basis. Given the perishable nature of the product, the egg and dairy vendors directly stock the store on a daily basis. Without this support, the stores would be completely out of stock of this merchandise within two days. Further, approximately 8% of all shoppers purchase this merchandise category on a given shopping trip to the Debtors'

stores. I believe that without this product category, shoppers will be less likely to choose Kmart for their daily shopping needs, thus severely impacting the Debtors' overall sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $6.8 million to egg and dairy vendors.

Advertising

187. The Debtors' weekly sales volume is highly dependent on their weekly newspaper circular program. Approximately 30%, or $11 billion of total sales are generated via advertised items. The Debtors print approximately 78 million circulars each week. These circulars arc distributed nationally via newspaper to the Debtors' markets. I believe that continuation of the entire circular advertising program, including circular layout and development, commodity paper procurement, circular printing, and newspaper placement and distribution, is critical to the ongoing health of the business. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $37 million to newspapers, ad production business, printers, and commodity paper suppliers.

* * *

Reclamation Claims

195. Prior to the date hereof, the Debtors received demands from several parties asserting a right of reclamation pursuant to Section 2-702(2) of the Uniform Commercial Code (the "UCC"). Moreover, as a result of the commencement of

these cases, the Debtors expect to receive numerous reclamation claims pursuant to section 546(c) of the Bankruptcy Code (collectively, the "Reclamation Claims"). The Reclamation Claims request That the Debtors either return certain goods (collectively, the "Goods") purportedly delivered to the Debtors on or prior to the commencement of these cases.

196. It is of paramount importance for the Debtors to maintain normal business operations and avoid costly and distracting litigation relating to Reclamation Claims. I believe that if the Debtors are unable to establish a global set of reclamation procedures to resolve the Reclamation Claims, they will be faced with the prospect of simultaneously defending multiple reclamation adversary proceedings at a time when the Debtors need to focus on critical aspects of the reorganization process.

197. Although the Debtors have not completed their review of these demands, they believe that many of the Reclamation Claims may be valid, in whole or in part, subject to certain defenses the Debtors may have to such demands. In addition, while the Debtors do not concede that any of the elements necessary to prove a right of reclamation have been shown by any of their vendors, the Debtors should seek to adopt a uniform procedure for determining and settling all valid Reclamation Claims so that litigation regarding Reclamation Claims does not interfere with the Debtors' reorganization efforts.

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198. I believe that many Sellers will attempt, pursuant to section 546(c) of the Bankruptcy Code, to assert their right to reclaim Goods delivered to the Debtors shortly before or soon after the Petition Date. Indeed, certain Sellers have already sent prepetition notices of reclamation and these Sellers may attempt to reclaim their Goods and otherwise interfere with the sale of Goods delivered to the Debtors within any applicable reclamation period. As a result, the Debtors' business operations may suffer and management's attention will be diverted from important operational issues in order to deal with the reclamation claimants.

* * *

FURTHER AFFIANT SAYETH NOT.

s/ Charles C. Conaway
Charles C. Conaway

Sworn to before me this 22nd
day of January, 2002

s/ Angeline M. Negron
Notary Public

APPENDIX H — COMPLAINT TO AVOID TRANSFER OF PROPERTY AND FOR RECOVERY DATED JANUARY 22, 2004 AND FILED JANUARY 26, 2004

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Chapter 11

Case No. 02 B 02474
(Jointly Administered)
Honorable Susan Pierson Sonderby

In re:

KMART CORPORATION, et al.,

Debtor.

KMART CORPORATION,

Plaintiff

v.

IRVING PAPER, INC. aka IRVING PULP PAPER SALES, J.D. IRVING, LIMITED,

Defendant.

COMPLAINT TO AVOID TRANSFER OF PROPERTY AND FOR RECOVERY

Appendix H

Plaintiff Kmart Corporation ("Kmart"), the reorganized debtor herein, brings this adversary Complaint against IRVING PAPER, INC. ("Defendant"), stating as follows:

VENUE AND JURISDICTION

1. Plaintiff is a Michigan corporation with its principal place of business in Troy, Michigan. Kmart confirmed its First Amended Joint Plan of Reorganization, as modified (the "Plan") on April 23, 2003. The Plan became effective on May 6, 2003. Kmart possesses standing to bring this action pursuant to the terms of the Plan.

2. This adversary proceeding is brought pursuant to, and under, Rule 7001 of the Federal Rules of Bankruptcy Procedure. This Court has subject matter jurisdiction over this action pursuant to 11 U.S.C. §549 and §1142 and 28 U.S.C. § 1334 because it arises under the United States Bankruptcy Code ("Bankruptcy Code") and is related to the above-captioned case. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

3. Venue is proper in this District pursuant to 28 U.S.C. § 1409(a).

GENERAL ALLEGATIONS

4. On January 22, 2002, Kmart and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession filed a voluntary petition for reorganization pursuant to Chapter 11 of the Bankruptcy Code. On January 25, 2002, this Court authorized the

payment of prepetition claims to certain critical trade vendors, including the Defendant ("January 25, 2002 Order"). Pursuant to that authorization, Kmart paid the Defendant $3,254,072.63 (the "Payment") near the outset of these bankruptcy proceedings.

5. Capital Factors, Inc., a factoring agent for a number of Kmart's apparel suppliers holding millions of dollars in unsecured claims against the bankruptcy estate, appealed the January 25, 2002 Order to the District Court. On April 10, 2003, the District Court reversed this Court, finding that payments for prepetition claims such as those enabled by the January 25, 2002 Order, "simply are not authorized by the Bankruptcy Code." *Capital Factors, Inc. v. Kmart Corporation*, 291 B.R. 818, 823 (N.D. Ill. 2003). The ruling of the District Court is on appeal to the Seventh Circuit Court of Appeals.

6. Kmart informed the District Court that, by the time of the appeal, it had already made disbursements to critical vendors such as the Defendant. The District Court nonetheless held that "it is not too late to order that the monies be returned." *Capital Factors*, 291 B.R. at 824. In furtherance of that ruling, Kmart now seeks avoidance and recovery of its prepetition payment to the Defendant.

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COUNT I

(For Avoidance and Recovery Pursuant to 11 U.S.C. §§ 549, 550)

7. Kmart hereby realleges and incorporates by reference paragraphs 1 through 6 above as though fully set forth at length.

8. Kmart transferred money to the Defendant after the January 22, 2002 commencement of these bankruptcy proceedings.

9. Pursuant to the decision of the District Court more fully described above, the Payment constitutes an unauthorized postpetition transfer of property of Kmart's estate. Accordingly, the transfer is avoidable pursuant to 11 U.S.C. § 549, and Kmart may recover the value of the transfer pursuant to 11 U.S.C. § 550.

WHEREFORE, Kmart requests that the Court enter judgment: (1) avoiding the above described transfer pursuant to 11 U.S.C. § 549; (2) granting Kmart a judgment against the Defendant pursuant to 11 U.S.C. § 550 for the full amount of the Payment, with lawful pre- and post-judgment interest and costs; and (3) granting such other and further relief, at law or in equity, as appropriate under the circumstances.

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COUNT II

(For Avoidance and Recovery Pursuant to 11 U.S.C. § 105)

10. Kmart hereby realleges and incorporates by reference paragraphs 1 through 9 above as though fully set forth at length.

11. 11 U.S.C. § 105 provides this Court with the power to enter any order that is "necessary or appropriate to carry out the provisions of this title." Since the January 25 Order has been reversed, it would be contrary to the Bankruptcy Code and inequitable for Defendant to be permitted to retain the Payment and thereby be paid in full on its pre-petition claim when all other unsecured creditors were not paid in full.

WHEREFORE, Kmart requests that the Court enter judgment: (1) avoiding the above-described transfer pursuant to 11 U.S.C. § 105; (2) granting Kmart a judgment against the Defendant for the full amount of the Payment, with lawful pre- and post-judgment interest and costs; and (3) granting such other and further relief, at law or in equity, as is appropriate under the circumstances.

DATED: January 22, 2004.

Appendix H

KMART CORPORATION
By William J. Barrett
One of its attorneys

William J. Barrett (6206424)
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APPENDIX I — EXCERPTS FROM TRANSCRIPT OF PROCEEDINGS DATED JANUARY 22, 2002

IN THE UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 02-B 02474

JANUARY 22, 2002
4:00 P.M.
Chicago, Illinois

KMART CORPORATION,

Debtors.

TRANSCRIPT OF PROCEEDINGS BEFORE THE HONORABLE SUSAN PIERSON SONDERBY
APPEARANCES:

For the Debtor:	Mr. Jack Butler; Mr. Eric Ivester;
For the U.S. Trustee:	Ms. Kathryn Gleason;
For Footstar, Inc.:	Mr. David Cleary;
For Cardinal:	Mr. Ronald R. Peterson;
For Penske and Sara Lee:	Mr. David Missner;
For Ramco Gershenson, New Plan Excel Realty Trust, the Rouse Company Affiliates:	Ms. Synde Keywell;

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For G E Capital:	Mr. Sheldon Solow; Mr. Gary Holtzer;
For Disney:	Ms. Deborah Thorne;
For Comerica:	Mr. Kurt Carlson
For Fleming	Mr. John Delnero

[2] APPEARANCES

For Capital Factors	Mr. Steven Towbin;
For VS Food Service:	Mr. Clinton Hansen;
For the SEC:	Ms. Angela Dodd;
For JP Morgan Chase:	Mr. Jeffrey Marwil; Mr. Brian Graham; Mr. Robert Scheibe; Mr. Jay Teitelbaum;
For Various Unsecured Creditors:	Mr. Randall Klein;
For Knight Ridder:	Mr. Joseph Frank;
Court Rep order:	Amy B. Doolin, CSR, RPR U.S. Courthouse 219 South Dearborn Chicago, Illinois 60604

[3] KMART CORPORATION
02 B 2474
January 22, 2002

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[4] THE CLERK: Now taking up Kmart Corporation, 02 B 2474.

* * *

CHARLES CONAWAY, WITNESS, SWORN

DIRECT EXAMINATION

BY MR. BUTLER:

Q Mr. Conaway, what is your position?

A I'm chief executive officer of Kmart.

Q How long have you been in that position?

A Since May of 2000.

Q Have you been in the courtroom during the presentation of the debtors' critical prepetition trade vendor motion?

A Yes, sir.

[140] Q Did you play any role in making a business judgment with respect to whether this motion would be brought before this court?

A Absolutely. I led the role.

Q Would you describe what your role was, please.

Appendix I

A We have over 4,000 vendors, and we looked with an incredible amount of analysis, and not just from a tactical standpoint but from a strategic standpoint, on what vendors could potentially have serious harm to the business if we were not able to continue. And we came down to a very small list, which is the one that was presented to the court.

* * *

BY MR. BUTLER:

Q You also testified in your affidavit, Mr. Conaway, to advertising issues. Can you explain to the court why advertising is considered a critical vendor when you've excluded so many other vendors from this program?

A Yeah. We are a high-low retailer. High-low retailer meaning that our main way of going to market is with an advertising program. We have a ROTO (phonetic) or circular that is out in the market every Sunday, 52 weeks a year, and then we also have additional advertising throughout the year in addition to that, that may break midweek or around a holiday, depending around critical sales periods.

Our business, as I mentioned, about 20 percent of our business is really driven by this ROTO. It is a critical element. Not just those sales, but what it does to the overall business. So we use the ad not just to drive promotional merchandise, but also to [150] drive the footsteps into the stores so we can sell other things that are not in it.

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Our ROTO program is all based primarily with major newspapers, and local newspapers in smaller markets. We have no alternative in most of the major markets. If we were not to get placement in an ad program, it would be devastating to the program, to our overall business model.

THE COURT: Could you explain what this entire circular advertising program, including circular layout and development, commodity paper, procurement, circular printing, newspaper placement and distribution, is.

THE WITNESS: Yeah. That whole program is the production of our circulars, which for the most part, your Honor, gets inserted into the newspaper every Saturday or Sunday, depending on the market. Our ad layout, essentially we are working about 12 weeks out, meaning items that are going to be dropping in 12 weeks from now, the actual circular is already done. So there is not a long lead time to do that.

The program is worked out every week, coordinated with our supplier base to make sure that we have the appropriate in-stock position. If we don't, rain check is a critical component to not disappoint our [151] customer. And that whole production of that ad is done through the various components that you asked.

THE COURT: So you have planned now for circulars to be inserted in newspapers going out 12 weeks?

THE WITNESS: Yes. This week would be for 12 weeks out, would be final. So as of next week we couldn't change anything in that circular, the actual physical circular.

* * *

Q All right. The last question I want to ask you, Mr. Conaway is you heard, I think during this hearing, the court's concern about how you differentiate between these vendors that you have deemed as critical and your other 3,995 vendors. And can you explain to the court in your own words how you reached the business judgment that these vendors ought to be brought forward on this program as opposed to the other nearly 4,000 vendors.

A Yes. There is really two dimensions. One was strategically of what does it mean for the business, meaning what is its role; within the category I talked about, Fleming, and how important that is from a commodity and frequency building standpoint. And the second one, quite frankly, which was the overriding one, was do we have any alternatives. In virtually all of [154] these cases from a practical matter when we walked through them, we don't have any viable alternatives. And given that we would have to exit that business, it would severely deteriorate the business in any one of those segments.

* * *

MR. TOWBIN:

* * *

[135] The problem I have is that if you grant this motion then the next things that happens is if Mr. Peterson is wrong in the prior motion and he's unsecured, they're going to say, well, he's vital, you know, so we've got to have him. So we're now going to pay the $37 million to him. Then the

next thing, you know, is the next guy who's got a consignment, GE Credit or whoever, and maybe their goods are, you know necessary. Everybody's goods are necessary.

The problem I have with this is that it's only a little bit of money, it's you know, done all over and its a Delaware kind of thing, you know, is that the Bankruptcy Code doesn't allow for this. And I think we have to make a decision either we're going to follow the Bankruptcy Code or we're not. This doctrine of necessity, Your Honor that I think — and there's lots of, you know, law on that. It started with the railroads, you know, and equity receiverships in the 1890s, the public good and it's really never been applied, you know, in this jurisdiction.

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APPENDIX J — EXCERPTS FROM TAPE TRANSCRIPTION DATED JANUARY 22, 2004

TAPE TRANSCRIPTION

RE: KMART CORP. v. CAPITAL FACTORS, INC.

U.S. COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

ORAL ARGUMENT - JANUARY 22, 2004

Transcribed by: Theresa Bergstrand, LSR
Brandon Smith Reporting Service, LLC
44 Capitol Avenue
Hartford, CT 06106
(860) 549-1850

* * *

SEVENTH CIRCUIT: So it's your view that none of this is done at arm's length, I take it? When you talk about cutting deals, that doesn't sound like you think it's arm's length.

MR. TOWBIN: No, I didn't mean to imply that, Your Honor. I think there was negotiation, there might have been negotiation pre-petition with some of the major vendors, but there was probably a negotiation post-petition as far as that. I don't mean to imply that there was any underhanded methods here at all.

* * * *